Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:PEN:PHI:TL-N-6638-98
DABreen

date: MAY 02 1999

to: Chief, Quality Measurement Branch, Pennsylvania District

from: Assistant District Counsel, Pennsylvania District, Philadelphia

subject: [redacted] - **Request for Advice**

This memorandum is in response to an inquiry from Revenue Agent Olga Singer, E:1843. Our response is forwarded to you for coordination purposes.

Facts

Two shareholders are investors in numerous operating partnerships and S-Corporations. In order to provide a ready source of funding for these entities, the shareholders created an subchapter-S corporation, "A" Company, into which they deposit funds. "A" Company maintains a "common account" for this purpose and acts as a "middle entity" between the two principal shareholder/partners and their various operating entities. This account is not maintained in the name of any one of the specific operating companies, nor is it in the names of the shareholders.

The funds are identified on "A" Company's books as a loan payable to the shareholders. Once "A" Company loans funds to one of the operating entities, the borrowing entity records the receipt of funds as a loan payable.

The representative argues that the Service should disregard the separate identity of each entity and treat transfers of funds from the shareholders to "A" which are subsequently loaned by "A" Company to the various partnerships and subchapter-S corporations as being loans directly from the shareholders. In other words, the taxpayer urges the Service to ignore the existence of "A" Company in this scenario.[1]

[1] At the outset, we encourage the examiner to secure copies of all loan agreements, promissory notes, and other evidence establishing the parties to the various loans and advances. This information may ultimately be necessary for the Service to rebut the taxpayer's argument that the various entities act "as one" for federal income tax purposes.

Issue

Are the funds transferred into the "common account" maintained by "A" Company bona fide loans when they are transferred into the account for purposes of computing a shareholder's basis in a subchapter-S corporation? If not, do they increase basis when they are loaned by "A" Company to one of the operating entities?

Response

Based on the facts presented, funds which qualify as bona fide indebtedness from the shareholders to "A" Company may increase shareholder basis in "A" Company. Additional analysis is required by the examiner to make this determination. However, funds transferred or loaned from "A" Company to one of operating entities do not increase basis in the shareholders' stock in these other entities, because the loans are not directly from the shareholders.

Legal Analysis

Internal Revenue Code § 1366 permits shareholders in a subchapter-S corporation to deduct their pro rata share of losses. Internal Revenue Code § 1366(d) limits the amount of this deduction to each shareholder's adjusted basis in stock and the adjusted basis of any indebtedness of the corporation to the shareholder, determined as of the close of the taxable year.

Case law has repeatedly held that the indebtedness must be that of the corporation **to the shareholder.** Any indebtedness must run directly to the corporation's shareholders. Borrowings from an entity in which the shareholders have substantial or even identical ownership do not qualify. *Hitchins v. Commissioner*, 103 T.C. 711 (1994), *Shebester v. Commissioner*, T.C. Memo 1987-246, *Burnstein v. Commissioner*, T.C. Memo 1984-74, *Frankel v. Commissioner*, 61 T.C. 343 (1973), *Prashker v. Commissioner*, 59 T.C. 172 (1972).

The facts presented by the revenue agent suggest that the funds are not transferred directly from the shareholders to the operating entities, but from a middle, related entity, "A" Company. The facts state that funds are freely transferred into "A" Company by the shareholders and then loaned by "A" Company to the various partnerships and subchapter-S corporations, depending on which one is in need of cash at the moment.

With respect to "A" Company, which carries the funds on its books as a loan payable to the two shareholders, funds transferred into "A" Company by the two shareholders may increase shareholder basis, if it qualifies as bona fide debt when transferred into "A" Company. The examiner should examine the loan documents or other evidence available to ascertain whether these transfers constitute bona fide indebtedness.

Following the court's rationale in *Burnstein* and the other cited cases, however, when "A" Company subsequently loans the funds to one of the operating partnerships or subchapter-S corporations, this subsequent loan has no effect on the basis of stock in the operating entity in the hands of the two shareholders, because the loan is not directly from the shareholders. For the debt to be included in the shareholder's basis, the shareholder must make an actual economic outlay and directly incur the debt. *Wise v. Commissioner*, T.C. Memo 1997-135, *Bhatia v. Commissioner*, T.C. Memo 1996-429, *Underwood v. Commissioner*, 63 T.C. 468 (1975). The facts presented here do not support such a finding. In fact, it seems clear that the loan from "A" Company to the related entity is not directly from the shareholders.

If you or Revenue Agent Singer have any additional questions, please call Senior Attorney David A. Breen at 215-597-3442.

Joseph M. Abele
JOSEPH M. ABELE
Assistant District Counsel